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Islahi, Abdul Azim

Islamic Economics Research Center, KAU, Jeddah, KSA

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Obstacles in the way of Islamic banking and finance in India

*Abdul Azim Islahi**

Abstract. The present paper aims to give a brief account of the main difficulties faced by the movement of Islamic banking and finance in India. Some of these obstacles may not be special to Indian case. However, their intensity becomes many folds due to prevailing condition of suspicion or indifference and absence of executive and enforcing power. The purpose of highlighting these issues is to draw the attention of scholars and business activists to think over the measures that may be adopted to overcome these difficulties.

The modern history of Islamic banking and finance in India originated in the wake of controversy that arose in the second quarter of the 20th century regarding the legitimacy or otherwise of bank interest and which developed into consensus like opinion on its prohibition.¹ This led to the discussion of finding the alternative arrangement based on Islamic principles. As a result some valuable academic works appeared which were also the first and pioneering writings in the development of modern Islamic economic theory.² But no worth mentioning institution of Islamic finance could be established in the first half of twentieth century. The second half saw forthcoming of a chain of Islamic financial institutions either in the form of interest free lending societies or interest free participatory investment and finance houses. However, a full-fledged Islamic bank remained still a dream for Indian Muslims. Even the interest free non-banking financial institutions could not present any bright record or successful story due to various obstacles discussed below.

The first and the foremost obstacle in the establishment of Islamic banking in India is the legal hindrance. The very law of banking in India does not permit to establish a bank without interest. Section 17 of RBI Act 1934 and section 24 of the Banking Regulation Act 1949 require the commercial banks to invest a portion of their deposits in interest bearing government and public sector securities. At one time the legal reserve and forced investment under cash reserve ratio (CRR) and statutory liquidity ratio (SLR) amounted more than 50% of banks' deposits. Now they have been drastically reduced. But simply removal of legal hindrance will not ensure establishment of a successful competitive Islamic bank. There are a number of other obstacles, discussed below, in the way of Islamic banking and financial companies that have to be removed.

It may be noted that the existing government rules could have been used to establish interest free investment companies under the category of non-banking financial companies (NBFCs) on Islamic lines of varying degrees. The Islamic business activists noted it only lately and made certain experiments.³ But the growth and performance of interest free financial institutions has not been satisfactory due to various constraints.

The frequent changes, though for genuine reasons, in to regulatory framework of Indian financial sector become an important obstacle.

while some of these changes were in favour of Islamic financial institutions, a majority of them hindered their advancement. Earlier NBFCs were governed by Companies Act 1956, which did not even contain the definition of a finance company. The registration of these companies with RBI was made compulsory during April 1993 to March 1995. The government enacted RBI (Amendment) Act 1997, which conferred, wide ranging powers on RBI for controlling the functions of NBFCs. The latest amendments to NBFCs guidelines state that "An NBFC having certificate of registration and otherwise entitled to accept public deposits is allowed to open its branch/office or allow its agents to operate for mobilization of public deposits within the state where its registered office is situated if its NOF (not owned fund) is up to Rs. 50 crore and anywhere in India if its NOF is more than Rs. 50 crore and its fixed deposits programmes have been rated by one of the approved credit rating agencies at 'AA' or above.⁴ These amendments clip the wings of all Islamic financial companies (and they are already few) as none of them qualifies to operate beyond the state of its registered office.

Another trouble comes due to unequal treatment of debt and equity fund. The capital of Islamic financial companies is equity-based operating through profit and loss sharing. Under the existing government rules profit is taxed while interest is exempted from tax on the ground that it is a cost item. This puts the Islamic financial institutions in the disadvantaged position. In the annual budget of 2000-2001 the rate of tax on dividends has been increased from 10% to 20%.

Islamic financial institutions in India are working in an environment which is secular and interest-based. It is but natural in such circumstances to be deprived of official sympathy and patronage. Due to this fact, it is sometimes very difficult to get certain provisions of Islamic banking and finance executed and arising disputes resolved.

While conventional commercial banks and cooperative societies have the facility of deposit insurance and credit guarantee, no such facility is available for Islamic banking and financial institutions which develops sense of insecurity and lack of confidence.

In addition to non-availability of Islamic insurance schemes, lack of interest free instruments, undeveloped Islamic primary market and non-existence of secondary market for Islamic product are some other serious problems of Islamic banking and finance in India. It may be noted that conventional banks have various types of financial products for investment. But the Islamic institutions have only a few traditional avenue of investment which limits their competitive capability.

The Islamic spirit requires that the institutions operating on interest free basis should work in coordination and cooperation of each other. But the business interests and occupational rivalry very often make them indifferent and non-cooperative to each other. Thus, the benefits of joint venture, research and experiments, formation of block, institutional lending, etc. which could have strengthened them are not enjoyed by them.

Again the transparency in profit distribution, proper documentation, regular balance sheet, trained personnels, financial expertise, standard accounting procedure, compliance to existing government rules, along with the *Shar'iah* principles are necessary elements to promote and

restore' the confidence of investors. Unfortunately on all 'these issues, Islamic financial institutions in India have shown a mere failure.

Since under profit and loss sharing partnership of *mudarabah*, the capital loss is always borne by the investor, there is always fear that the entrepreneur may give misstatement about the loss or under-report the profit as the moral and ethical condition of people is not very reliable. Unless a mechanism is evolved to check such happenings, the investor's confidence cannot be fully secured and an atmosphere of suspicion will be surrounding him.

Interest based-advances and credits have built-in provision for penalizing the defaulters or late payers. Islam exhorts its followers to give time to a poor, till he is able to return his debt. But there is no clear guidance about dealing with the rich defaulters. It is generally complained that this provision has been misused by the rich and wealthy debtors, which slows down the operational capacity of the interest free institutions. In the opinions of some contemporary scholars, the rich defaulters should be fined but the amount should be spent on charity.⁵ The issue needs further analysis and discussion to reach a consensus.

Last but not the least. There are several agencies to rate credit worthiness of interest based financial companies. But there is no such arrangement on the part of Islamic institutions. Due to this many foul and fraudulent companies entered the Islamic milieu and with crores of rupees fled by night. In many cases they presented the best example of hypocrisy and dichotomy by challenging the institution of interest and at the same time practicing the interest themselves.

There is also lack of qualified *Shari'ah* experts who could understand the intricacies of modern business styles. Sometimes these companies keep a traditional *alim* (religious scholar) in the board of their directors only to befool the public and encash his popularity.

To end the paper on an optimistic note I would like to submit that most of the obstacles mentioned above are already subject of concern for Islamic economists in India and abroad. And where there is will, there is a way. However, the main challenge facing Islamic banking in India is how to communicate the idea to decision makers as a viable alternative. Done effectively, this, in a democratic country, may eventually pave the way for wider acceptance of interest free banking which is currently perceived as something 'needed' by Muslims alone. As a matter of fact, reaching out to the general Indian population with the message 'that Islamic interest free banking is more conducive to efficiency, stability and social justice is necessary for the realization of the full potential of Islamic banks in India. The democratic set-up of the country and its recent policies in favour of globalization, liberalization, etc. provide suitable environment to establish such a bank with or without collaboration of foreign Islamic banks.

Another front, which demands our immediate attention, is formation of Islamic rating agency so that vested interest may be eliminated. They want to hijack the movement of Islamic banking and finance for their selfish ends and ultimately defeat the very purpose of the

movement. There is urgent need to increase the research and investigation to remove the hurdles in the way of Islamic banking and finance and expose those who exploit the sentiments under the guise of practicing interest-free system while in reality they are not.

Notes

1. For a description of this controversy one may refer to Fazlur Rahman, *'Tijarti Sud Tarikhi aur Fiqhi Nuqta-e- Nazar Se'* (Commercial Interest from the stand point of History and Islamic Law) (Urdu), Aligarh Muslim University, 1967.
2. Although a number of works appeared around the mid 20th century in which *Mudarabah* was suggested as an alternative to interest based banking system, the first clear exposition of the theory of Islamic banking was drafted by Dr. M. Uzair - a graduate of Allahabad University. See, Uzair, Muhammad, *"An Outline of Interest-less Banking"*: Karachi/Dacca, Raihan Publications, 1955.
3. In one of his articles Mr. M. H. Khatkhatay expressed his grief over the Islamic financial institutions for not being able to exploit opportunities available in India for many decades after independence. Khatkhatay, M.H. *"Islamic Investment Activities in India"*: Paper presented at the second conference on Islamic Banking and Finance, Toronto, Canada, June 1997, Mimeo, p. 2.
4. *The Journal of Banking*, New Delhi, Vol. 19, No.4, April 2000, p. 10.
5. Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, Karachi, Idaratul Ma'arif. 1998, pp. 132-139.

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*Dr. Islahi is Reader / Associate Professor in the Department of Economics, Aligarh Muslim University.